If the regulators end up trying to go for detailed rules, this effectively results in regulators and governments trying to run banks, and with regret that can only end in tears. Just look at what the governments are actually doing at present – can much of it make sense? If the crisis was caused by problems of liquidity and rules requiring assets to be priced to a market value which massively understates inherent value, then these are the issues you need to deal with. There is no evidence that this was understood by the G20.

The Role of Non-Executive Directors

Separately we have seen thoughts that non-executive directors should be in a position to question management appropriately. Clearly risk specialists are the ideal candidates for such roles and we think that this is a useful addition to the debate. As a firm we possess access to one of the largest groups of experienced risk professional in the world and anticipate receiving regular requests for non-executive directors. Our risk specialists all have more than 20 years of relevant experience and can add significant value to the Board discussions at any financial institution.

New High Level Principles for Risk Management

The Committee of European Banking Supervisors

On 8 April 2009 CEBS issued a consultation paper (CP24) on High-level principles for risk management. According to this analysis, “EU and international supervisory bodies have produced a comprehensive set of guidelines covering all aspects of risk management”. You may well disagree with this statement, since our view is that such principles are inconsistent and incomplete. The CEBS does state that “the coverage of the guidelines is somewhat fragmented”. They also note that CEBS’ guidelines have gaps in the following areas:

- Governance and risk culture
- Risk appetite and risk tolerance
- The role of the Chief Risk Officer and risk management functions
- Risk models and the integration of risk management areas
- New product approval policy and process

The CEBS has consolidated all of its principles and guidelines addressing risk management into a comprehensive guidebook.

CEBS state that these high-level principles proposed in CP24 should be considered both by institutions and supervisors within the supervisory review framework under Pillar 2 (i.e. the ICAAP).

Whilst these principles are aimed mostly at large and complex institutions, they can be adapted to any institution under review, taking into account its size, nature and complexity.

The High Level Principles

These fall under the same headings set out above. In this brief article we only set out a few issues of specific interest. For the full information, reference should be made to the original document.

1. Governance and Risk Culture

They require a comprehensive and independent risk management function under direct responsibility of
New High Level Principles for Risk Management

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the senior management. They also require that the management body have a full understanding of the nature of the business and its associated risks. Specifically they are looking for senior management with capital markets experience, although the key from our perspective is for the non-executive directors to be in a position to adequately challenge risk management.

They require that every member of the organisation must be constantly aware of his responsibilities relating to the identification and reporting of risks and that a consistent risk culture must be implemented, supported by appropriate communication.

2. Risk Appetite and Risk Tolerance

CEBS state that risk tolerance should take account of all risks, including off balance sheet risks. Then the paper requires management focus on consistency of targets, with responsibility residing with the management body and senior management.

In our opinion there is much confusion surrounding risk appetite and risk appetite modelling and it is perhaps disappointing that this paper does not really add any clarity to the issue. Risk appetite in our view is a single metric that is then converted into a series of measures as appropriate, driving behaviour and control systems appropriately. We are seeing many installations that are impossible to either use in practice or fail to add value to their institutions - and the solutions are having to be changed and simplified significantly. A little more clarity of thinking would be of assistance here. The remainder of this section repeats wording from the Bank for International Settlements (BIS) Sound Practices paper from 2003.

3. The Role of the Chief Risk Officer and the Risk Management Function

Basically there needs to be a person responsible for the risk management function across the entire organisation – and this means all risk types. They need to have sufficient independence and seniority to challenge (and potentially veto) the decision-making process and possess the expertise that matches the institution’s risk profile. From our experience many of the CRO roles do not have this level of authority. Further, the professionalisation of the risk management function is at a relatively early stage of development; so many risk professionals are only comfortable in certain risk areas. Perhaps they really understand credit risk, but not operational risk. Perhaps they originally commenced in market and liquidity risk, but counterparty credit risk is beyond them. As an enterprise risk management firm we recognise both the challenge and the opportunities that a developing ERM framework and CRO can provide to any firm.

Importantly CEBS state that risk management should not be confined to the risk management function, since it needs to be in the business. Perhaps this is one of the failings of certain functions we have seen, where the risk professionals have undertaken significant assignments without the business actually being impacted. This has to be the wrong approach since risk management facilitates the implementation of policies and procedures, rather than actually undertaking the primary transactions itself.

4. Risk Models and Integration of Risk Management Areas

CP24 requires firms to identify and manage all risks whilst avoiding over-reliance on any specific risk methodology or model. The requirement for a risk register would therefore appear obvious and we would suggest that this should be clearly linked to the control framework and risk appetite. These concerns over risk models have surfaced before, being prominent in the 2008 Banana Skins survey promulgated by the CSFI (Centre for the Study of Financial Innovation). CEBS raises concerns over the conceptual limitation of metrics and models, highlighting the need for qualitative and quantitative data to be combined, with stress tests being considered. This also provides many firms with a challenge related to the natural inaccuracy of much of the modelling that is conducted. This should not concern banks unduly since much of this data is actually required for strategic risk management as opposed to tactical risk management and accordingly the same level of accuracy is not necessary.
5. New Product Approval Policy and Process

There is nothing much in this section apart from a requirement for a new product approval policy and new product due diligence.

Conclusion

I am sure we will not be alone in thinking that the CEBS could have provided more useful guidance in such an important area. It is perhaps the issues that they have failed to address - in particular the development of an enterprise risk management framework and the role of the non-executive director - that provide us with the greatest disappointment.

There are however a few key messages, perhaps the loudest of which is that risk management is now central to the way that a institution operates and can no longer be relegated to a more junior level. The elevation of risk management as a principle driver must be welcomed and the CEBS therefore generally applauded for their added impetus.

What is the Turner Report?

Lord Adair Turner, Chairman of the FSA, has recently published his much heralded report on the credit crisis. He examines in sometimes tedious detail the causes of the failures leading to the crisis and then sets out his recommendations for the future.

It is worth noting that the UK’s FSA is the first major regulator to publish such a detailed report although its release just before the G20 Summit in London may be seen as both timely and pre-emptive. Some might argue that it actually was presumptuous. It is clear that Lord Turner and the FSA are hoping that their proposals will be both taken up in the UK and internationally. Many of the changes recommended by Turner go to the heart of the Basel Accord and impact on the international regulatory and supervisory frameworks.

Indeed, given the international and global nature of so many of the key market participants, really effective regulation can only work if it is implemented across each of the key financial jurisdictions on a consistent basis. Only by achieving this can regulatory arbitrage be avoided.

Turner’s View of the Causes of the Crisis

Turner identifies three underlying causes of the crisis:-

- Macro-Economic Imbalances
- Financial Innovation is ‘of little social value’ and
- Important Deficiencies in Key Bank Capital and Liquidity Regulations

These, Lord Turner says, were underpinned by an exaggerated faith in rational and self-correcting markets. He makes an obvious observation in stressing the importance of regulation and supervision being based on a system-wide “macro-prudential” approach rather than merely focusing solely on specific firms.